Regulation: ensuring it is fit for the future in unchartered territories

Economic regulation has one simple purpose: to create an environment in which customers get value for money. We, in the water industry, are entering unchartered territory – the regulatory techniques used with some significant success in the past are no longer appropriate; there are new challenges – some of which are known, for example likely higher levels of capital maintenance, some are yet to be fully understood, for example the impact of government policies to address climate change. Addressing the challenges ahead is no longer fully in the gift of companies in the way that they were. There is going to be a need to be more innovative, more flexible and more responsive to customers.

There should be no need to rehearse the achievements of the water industry. Indeed one issue may be that the industry has made the delivery of the improvements for which it has been responsible too easy. Many consider that the industry will simply continue to meet the challenges ahead in the same quiet and effective way. In my view this is just not an option.

There are a number of weaknesses inherent in the current regulatory framework...

A 'black box' process – regulators do not understand how companies put together business plans and companies do not understand how regulators reach their conclusions – de facto amending that plan.

Do customers feel **engaged** in the price determination process?

The five-year delivery cycle may be both too long and too short: large capital projects are unlikely to divide neatly into five year chunks and in some cases priorities can change during a five year period so more flexibility may be desirable.

The marginal cost of capital may be higher than the average for especially large or innovative projects or perhaps just when there is an opportunity to reconfigure assets (which may be more risky than replacing like with like).

Separate regulation of operating costs and capital expenditure: we should want to see the most cost-effective solution – not the best capital project.

There is an inherent bias towards capital expenditure: as such, it is better to own vehicles than to lease them, and better to build a reservoir than to buy water from a neighbour.

There may be a bias away from potentially more risky projects because of the way regulators both economic and quality report on progress. This leads to less innovation and therefore deprives customers of benefits. For example, the pursuit of a catchment management solution may earn little or no return for a water company, yet could be much cheaper for customers than the likely alternative of constructing an asset.

Econometric models served customers (and the industry) well. The comparisons that they facilitated were useful and led to substantial improvements. But these were born of a study of detailed costs and drivers triggered further pursuit of new and better information either to substantiate or undermine conclusions.

Business plans got to be so long that they were unactionable – and if unactionable, what is their point?

But perhaps the most worrying weakness in the current regulatory framework is that we, as economic regulators, end up second guessing the management of the company. And if we allow ourselves to second-guess a company without reasonable cause, is there not a risk that it is the regulator who sets the strategy? And does that not misalign responsibility and authority?

My response: the regulatory framework needs to be flexible, and should allow for value-adding investment to be made. The central issue is the price profile (and hence the perceived value for money) and that the rate of return earned should be reasonable. This requires transparency, quality, strategic dialogue and fewer, but more experienced, staff.

Reforming regulation in this way may result in cost reductions on both sides of the regulatory divide that are substantial!

One of the lessons that I have learned from the introduction of retail competition is that, notwithstanding the results of fairly extensive research, customers can behave differently when they have choice. We, as economic regulators, may not be best placed to know what customers actually want.

There also seems to be evidence that if there is space to innovate, a commercially minded company will seek to achieve the benefits that are available.

We have also seen quite directly how managements tend to respond quickly if their reputation is at risk.

Our approach in Scotland is to empower Scottish Water so that it takes full ownership of its business plan and its customers. As such it should be immediately accountable for its performance and any shortfall in performance would impact on its reputation.

Our approach foresees the conclusion of a regulatory contract between Scottish Water and its customers. This contract should be transparent and would be subject to rigorous monitoring, with managerial incentives closely tied to performance against the contract.

Our approach requires a number of evolutionary changes:

1. Focus on agreed outcomes; not on the ways in which these outcomes might be expected to be delivered.

2. Allow Scottish Water to retain the benefits of pursuing lower cost or better levels of service for a sufficiently long period that the company has achieved payback at a reasonable investment hurdle rate.

3. Provide a framework for returns earned by Scottish Water, including the sharing of higher returns with customers.

4. Allow for a higher return to be earned on innovative approaches – provided the ultimate cost is lower to customers. These returns should be available for the duration of the proposed project.

5. Ensure that customers, their retailers, third parties and the incumbent can benefit from innovative approaches.

6. Involve customers in decision making. Customers will have a view on how services should or could be improved – including, for example, the trade-offs between lower carbon, less certain, lower price and higher return options and more conservative, traditional approaches. To this end we are in the process of working with Scottish Water and Consumer Focus Scotland to establish a Customer Forum. This will include representatives of household customers, non-household stakeholders and the retailers.

So what would the business plan process look like under this outcomes-focused approach?

In Scotland we are aiming to agree some basic planning assumptions with Scottish Water before the company begins to write its business plan (the high-level objectives that underpin this business plan having already been set by Scottish Ministers).

These parameters are likely to include:

- a range for a reasonable cash return for the wholesale business;
- a range for operating costs and capital maintenance; and
- a range for growth in customer numbers.

Scottish Water will be free to use whatever assumptions it chooses but we would expect any significant deviation from these ranges (or if the best value for Scottish Water is always used) would have been discussed with and justified to the Customer Forum. The involvement of retailers could allow Scottish Water to be held to account as to why one company can offer a level of service that they may not. Agreement with the Customer Forum should be Scottish Water's ultimate aim. The Customer Forum will be, in effect, the jury which Scottish Water will have to satisfy.

This approach should ensure that there is no question that the business plan, written by Scottish Water, is owned by Scottish Water and will have been thoroughly discussed with customers. As such, the resulting charges should have much more legitimacy.

We envision a strategic dialogue, an environment in which the regulated company takes ownership of its plan and in which customers are much more engaged. It is therefore a substantial move away from the previous position, which was in danger of becoming more like a parent/(young) child relationship based on an adversarial game of second guessing and gaming – whether or not this was recognised or intended by the players.

The consequences for us as an economic regulator are significant. We will need less but better resources. In the event that Scottish Water were to fall short of its commitments to deliver outcomes, it would be for the Customer Forum, in the first instance, to challenge Scottish Water's senior management. In so doing, the Forum would have the benefit of the Commission's monitoring. Scottish Water would be fully aware of any such shortfalls because the outcomes of the regulatory contract are defined and agreed. If these were not resolved and the Commission had to intervene, it would be likely that there would be a substantial reputational cost for Scottish Water and the criticism could not be mitigated by suggesting capriciousness or micro-management on the part of the regulator.

And, as regulator, we will have to earn respect for our understanding of the strategic issues and challenges faced by the company and the trade-offs that are part of everyday life. Regulators should not create incentives – rather the focus should be on allowing the space and conditions for innovative approaches and enhanced returns for success. Understand the business, yes, but top-down not bottom up!

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